Should any working capital allowance be found to be appropriate, it should be on an industry-wide basis. The balance sheet approach is readily subject to manipulation and can result in an excessive rate base. While a lead-lag study would be necessary to establish an industry-wide allowance, its use on a continuing basis would be excessively burdensome on all involved.

g. Rate of Return

> We propose to establish a single rate of return for provision of regulated cable service by all cable operators for the purpose of setting rates based on a cost-of-service showing.[25/]

The Commission should establish a single rate of return for the provision of regulated cable service by all cable operators, just as it has maintained a single rate of return for the interstate access services of all local exchange carriers. The rate of return should be established to reflect the risk level inherent in the provision of regulated cable service. This risk is comparable throughout the nation. Individual company financial structures and arrangements should not be allowed to impose burdens on the ratepayers.

> We tentatively conclude that the choice of the surrogate to use in determining the rate-of-return of regulated cable service should be guided primarily by an assessment of risk. Thus, we propose to choose a surrogate that experiences the same approximate risk of economic losses the provision of regulated cable service. . . . We also solicit comment on whether a different surrogate should be used, such as regulated telephone companies.[26/]

25/ NPRM at 24, ¶ 46.

26/ NPRM at 28-29, ¶ 50.

The choice of the surrogate to use in determining the rate of return of regulated cable service should be guided primarily on the basis of risk. The appropriate surrogate on this basis is the local exchange telephone companies. Cable and local exchange telephone companies face virtually identical business risks. The core of each business is the local distribution of information over aerial or underground physical facilities. The inherent similarity of these businesses is currently manifesting itself in business alliances, but will someday (possibly very soon) be reflected in direct competition. Until that time, however, both industries are virtual monopolies in their historical segments of the industry, and face equivalent business risks.

The use of the cost of capital of the S&P 400 is no more appropriate now for the cable industry than it was in 1990 for the local exchange telephone industry, when the Commission stated emphatically:

> We simply do not believe that interstate access, which is a regulated monopoly business, is as risky as the average publicly-traded firm.[27/]

This belief, widely held in the financial community, is based on the premise that a regulated business finding itself in extremis can seek some type of regulatory relief, whereas publicly-traded competitive firms have far less recourse to reduce their risk. The Commission should accept this basic

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27/ Represcribing the Authorized Rate of Return for Interstate Service of Local Exchange Carriers, Order, 5 FCC Rec 7507 (1990), (1990 Telco Represcription Order), ¶ 162.

principle as a starting point for thinking about surrogate choice.

> Given market changes in the cost of debt and equity, we tentatively conclude that a rate of return somewhere in the range of 10% to 14%, after taxes, would reflect a reasonable balancing of subscriber and cable operator interests and that we could select a final rate of return within this range to achieve our balancing of goals for cost-based rates for cable service. We solicit comment on selection of a maximum rate of return for regulated cable service within this range.[28/]

The Commission should prescribe a rate of return for the cable industry no higher than that currently in effect for local exchange telephone companies. Indeed, the 11.25 percent rate of return currently in effect for local exchange telephone companies is almost certainly excessive in today's environment,[29/] where prime lending rates are in the middle single digit range. This return was adopted in September, 1990, and the cost of capital has fallen precipitously and continuously since then.

3. Cost Accounting Requirements

> We also solicit comment on whether we should establish a more comprehensive system of accounting for cost-of-service showings similar to the Uniform System of Accounts (USCA) for telecommunications companies set forth in Part 32 of the Commission's rules.[30/]

The Commission should establish a simple but uniform system of accounts for cable operators. The accounts listed in Appendix A to the NPRM appear to represent a satisfactory

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28/ NPRM at 30, ¶ 52.

29/ 1990 Telco Represcription Order, supra, ¶ 216.

30/ NPRM at 32, ¶ 58.

compromise between the need for reliable information and the need to minimize regulatory burden.

4. Affiliate Transactions

> We propose to establish affiliate transaction rules concerning transactions between the regulated and nonregulated portions of cable systems. We will adopt rules that will prevent cable systems, in cost-of-service showings, from imposing the costs of nonregulated activities on regulated cable subscribers through improper cross-subsidization. . . . We seek comment on this proposal to adopt affiliation transaction requirements [31/]

The Commission should adopt affiliate transaction rules for cable operators identical to those it has established for telephone carriers in Part 32.27 of its rules. The dangers of cross-subsidy between regulated and unregulated accounts without effective rules are just as great in the cable industry as in the telephone industry.

The treatment of transactions with affiliates from Part 32.27 of the Commission's rules will be effective in dealing with asset transfers into or out of the regulated accounts of cable operators. However, the mixed regulation scheme (having both benchmark and cost-of-service systems) proposed in this NPRM necessitates a new dimension of complexity. With a mixed regulation scheme a parent company could use transfers between affiliates under different regulatory schemes to inflate the costs of affiliates under cost-of-service systems and deflate the costs of affiliates under the prescribed benchmark. If the Commission chooses a mixed system, it must address this issue.

31/ NPRM at 35, ¶ 66.

One possible remedy for the potential problems introduced by a mixed system of regulation would be to increase the amount of information available to local franchising authorities. A cable operator with multiple affiliates, when submitting a cost-of-service study to the regulating authority of one affiliate, should submit the same study to all regulatory bodies that oversee all of the operator's affiliates (whether each affiliate is using a cost-of-service or a benchmark approach). At a minimum, all regulatory bodies should be informed of cost-of-service showings in affiliates related to their cable service provider, and should be able to obtain studies on request.

> We propose that an affiliated entity shall be an entity with a five percent or greater ownership interest in the cable operator . . .[32/]

This minimal standard for the establishment of an affiliate relationship for purposes of regulation is appropriate.

> We request comment on what method should be used to value affiliate transactions. In particular, we invite comment on whether we should require cable system operators to record affiliate transactions at prevailing company prices offered in the marketplace to third parties, whenever the supplying affiliate has established such prices.[33/]
>
> We also invite comment on whether to require cable systems to record affiliate transactions at their estimated fair market value.[34/]

32/ NPRM at 36, footnote 67.

33/ NPRM at 37, ¶ 68.

34/ NPRM at 37, ¶ 69.

Affiliate transactions should be recorded at a price as close to market price as possible. Recent sales to third parties should take precedence over estimated fair market value, since all estimations are subject to manipulation. The cable company, however, should also be required to report those transactions where they have sold assets at other than appropriate fair market value.

5. Streamlining Alternatives: Small Systems

> We solicit comment on what definition of small systems we should establish for purposes of cost-of-service requirements. Would small system streamlining provisions apply to systems with fewer than 1,000 subscribers owned or affiliated with multisystem operators (MSOs)?[35]

No. The definition of a small system should be stated in such a way that it is subject to a minimum of manipulation by cable operators. Therefore, we would count subscribers cumulatively, with all affiliates included in the calculation. Congress' clear intent was not to burden small companies, and also not to provide an incentive for large systems to fragment into affiliates and avoid regulation.

IV. PRODUCTIVITY OFFSET

> We solicit comment on whether there is a valid economic basis for assuming that cable service has been, and will be experiencing efficiency gains. We invite the submission of industry studies or other expert economic analysis. In undertaking expert analysis we invite parties to examine in particular, the following options: (1) no productivity offset; (2) a consumer productivity dividend of .5%; (3) a telecommunications industry adjustment between 3.0 (AT&T) and 3.3 (LECs);

35/ NPRM at 42, ¶ 78.

> (4) a different productivity offset for cable operators.[36/]

As stated earlier in these comments, there are a number of valid reasons for assuming that the cable industry will be experiencing efficiency gains. Prior to regulation, economic theory would indicate that cable companies would operate with a management and operations style inherent in an unregulated monopoly. Without economic incentive through competition or regulation, management had no pressure for efficiency. Subsequent to regulation, which emulates a competitive market, management will be under review and economic theory would indicate that such an industry would become more efficient.

The Commission should adopt a productivity offset of 3.3 percent for cable operators. This is the minimum offset currently approved for local exchange telephone companies. Given the basic similarity of the cable and local exchange telephone industries, the use of any lower offset would result in a growing windfall for cable operators. Indeed, the adoption of a 3.3 percent productivity offset will "provide an incentive for future efficiency gains and harmonize incentives for converging technologies."[37/]

V. COLLECTION OF INFORMATION

> We solicit comment on how we may best tailor the information we require to the cost-of-service standards and accounting requirements proposed herein.[38/]

36/ NPRM at 46, ¶ 85.

37/ NPRM, at 46, footnote 99.

38/ NPRM at 47, ¶ 88.

The Commission should require all systems to submit data annually. In addition to the data requested in Appendix B to the NPRM, the Commission should require an earned rate of return on rate base calculation with each report. Over time, such data has proven very valuable to regulators in the exercise of their oversight responsibilities. Each annual report should include an attestation by an independent auditor that the report has been prepared in accordance with the Commission's accounting and affiliate interest rules.

VI. CONCLUSION

The cost-of-service approach proposed by the FCC in this NPRM, particularly where it is offered to cable operators as a constantly available alternative to the benchmark approach, will be inordinately complex and burdensome to local franchising authorities acting as regulators, and will not result in the most reasonable cable service rates. Counsel to the Municipal Franchising Authorities instead support either a much simplified cost-of-service approach, or a benchmark and price cap approach refined to address and include cost-of-service issues. Should the Commission conclude that a cost-of-service alternative is nevertheless appropriate, it should take into consideration all of the issues addressed herein, and design its final rule to eliminate the unjust and unreasonable impact certain of its tentative conclusions would create for local franchising authorities.

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Respectfully submitted,

Janice L. Lower
Harold K. McCombs
Michael R. Postar
Tatjana M. Shonkwiler

Duncan, Weinberg, Miller & Pembroke, P.C.
1615 M Street, N.W.
Suite 800
Washington, D.C. 20036
(202) 467-6370

William H. Dannenmaier
Snavely, King & Associates, Inc.
1220 L Street, N.W.
Suite 410
Washington, D.C. 20005
(202) 371-1111

Counsel to the Municipal Franchising Authorities